IT 01-0046-GIL 05/15/2001 PUBLIC LAW 86-262/NEXUS

General Information Letter: Nexus determinations are generally not proper subjects of a letter ruling.

May 15, 2001

Dear:

This is in response to your letter dated March 7, 2001 in which you state the following:

xxxxxxxxxxxxxxxxxxx ("xxxxxxxxx"), a corporation organized under the laws of the State of Delaware, respectfully requests a letter ruling on the following question: Do the Commerce and Due Process Clauses of the United States Constitution preclude the State from imposing a tax on the income of a nondomiciliary corporation, such as xxxxxxxxx, that has no physical presence in the state and whose only contact with the State is the resale of telecommunications services to certain of its residents through an Internet-based interface?

xxxxxxxxx respectfully submits that these contacts do not establish a sufficient nexus between its activities and the State to allow for the imposition of a tax on the income of a nondomiciliary corporation.

I. FACTS

xxxxxxxxx is a Delaware corporation domiciled in xxxxxxxxxx, Massachusetts. xxxxxxxxx is an online reseller of long distance telephone and Internet services in all states and local exchange service in seven jurisdictions [Footnote: These are Massachusetts, New York, Pennsylvania, New Jersey, Delaware, Maryland, and the District of Columbia]. It neither owns nor leases any property in any states other than Massachusetts in reselling these services. xxxxxxxxx has broker states other than Massachusetts in reselling these services. xxxxxxxxx has broker relationships with other third party providers for the sale of other services, including wireless communications, propane, and home heating oil. xxxxxxxxx is not a reseller of these services, but rather receives a one-time bounty for acquiring the customer, who then does business directly with the third party vendor.

xxxxxxxxx provides these services through an on-line marketplace located at www.xxxxxxxxx.com. The company generates sales through this Internet website. xxxxxxxxx posts customer bills on the website, where they may be accessed by means of a user name and password. Customers who prefer may receive a paper bill through the United States mail. xxxxxxxxx has no retail stores, sales offices, direct sales representatives, independent contractors, samples, tangible personal property, inventory, deposits, vehicles, employees, real property or any other business premises in the State.

All sales relations and customer support functions are managed from our corporate headquarters located in xxxxxxxxxx, Massachusetts. xxxxxxxxx solicits sales, generates sales and invoices customers online using the Internet. xxxxxxxxx sets up the service(s) the customer(s) select(s), place the detailed bill online, and helps to automatically assist in deducting payments. All service offerings are placed directly by customers over the Internet and accepted (or rejected) in Massachusetts. Most customer payments are remitted directly to xxxxxxxxx by use of credit card payment on line.

xxxxxxxxx is registered in all states for state required transactional excise taxes (e.g., sales and use tax, telecommunications taxes, and public utility fees). xxxxxxxxx has filed annual reports with all states in which it is registered to conduct business.

II. DISCUSSION

In general, "a State may tax a proportionate share of the income of a nondomiciliary corporation that carries out a particular business both inside and outside that State." *Hunt-Wesson, Inc. v. Franchise Tax Board of California*, 528 U.S. 458, 460, 145 L.Ed.2d 974 (2000). A State may not, however, tax income arising out of interstate activities – even on a proportional basis – unless there is a "minimal connection" or "nexus" between such activities and the taxing State, and a "rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 165-166, 77 L.Ed.2d 545, 103 S.Ct. 2933 (1983). Without such a nexus and rational relationship between apportioned income and intrastate value, a tax fails to meet the due process requirements imposed on the States by the Fourteenth Amendment. *Quill Corporation v. North Dakota*, 504 U.S. 298, 306, 119 L.Ed.2d 91, 112 S.Ct. 1904. Even a tax that passes muster under the Fourteenth Amendment must not, however, impose an undue burden on interstate commerce, a result that would be forbidden by the dormant Commerce Clause of the United States Constitution. *Id.* At 309. The United States Supreme Court "will sustain a tax against a Commerce Clause challenge so long as the tax (1) is applied to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the State." *Id.* at 311, citing *Compete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 51 L.Ed.2d 326, 97 S.Ct. 1076 (1977).

In *Quill*, *supra*, the Court retained a bright line test for the fulfillment of the "substantial nexus" prong of the Commerce Clause analysis, holding that a State could not impose sales and use taxes on a nondomiciliary corporation that did not have a physical presence in that state. *Id.*at 314-15. The Court thus reaffirmed a central holding of *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753, 87 S.Ct. 1389 (1967), "that a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." *Quill Corporation v. North Dakota*, 504 U.S. at 311.

The most recent cases decided by the United States Supreme Court show that, while xxxxxxxxx arguably has sufficient contact with nondomiciliary states to meet the "minimal connection" requirement for purposes of the Fourteenth Amendment, xxxxxxxxx has no "substantial nexus" with states other than Massachusetts and Delaware that would allow taxes on income imposed by those other states to survive a Commerce Clause challenge. In *Quill* and related cases, the Court held that "the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. We have, therefore, often identified 'notice' or 'fair warning' as the analytic touchstone of due process nexus analysis." *Quill Corporation v. North Dakota*, 504 U.S. at 312. At this point, xxxxxxxxx will not argue that it would offend due process considerations should a State court or agency seek to assert jurisdiction over xxxxxxxxx for purposes related to the business it conducts with citizens of that State through its Internet website. In fact, in some instances, xxxxxxxxx submits voluntarily to such

jurisdiction. For example, intrastate telephone traffic is subject to the jurisdiction of the State public utility commission, and xxxxxxxxx submits to the jurisdiction of that body by affirmatively seeking approval to resell such services within the borders of the State. Issues involving xxxxxxxxx that are related to such services are properly within the jurisdiction of the State Commission or a State court upon judicial review of decisions of the State Commission.

At the same time, however, xxxxxxxxx has no contacts with nondomiciliary states that would form the "substantial nexus" required for a tax on its income to pass muster under the Commerce Clause. xxxxxxxxx has no assets, employees, facilities, contractors, or physical presence of any kind in the nondomiciliary states. Its only contact with its customers is by mail or common carrier, in the form of telephone calls to customer service or visits to the xxxxxxxxx website through Internet service providers using common carrier networks. In that respect, xxxxxxxxx is even further removed from nondomiciliary states than the mail order businesses at issue in cases such as *Bellas Hess, supra,* and *National Geographic Society v. California Board of Equalization*, 430 U.S. 551, 559, 51 L.Ed.2d 631, 97 S.Ct. 1386 (1977). A mail order business arguably has title to property delivered to its customers within the borders of the State seeking to impose a tax; xxxxxxxxx takes no such title to the intangible services it resells to customers in nondomiciliary States. *See also Goldberg v. Sweet*, 488 U.S. 252, 263, 102 L.Ed.2d 607, 109 S.Ct. 582 (1989) (expressing "doubt that termination of an interstate telephone call, by itself, provides a substantial enough nexus for a State to tax a call).

Furthermore, allowing the forty-eight States other than Massachusetts and Delaware to tax the income on xxxxxxxxxxx interstate activities would place a tremendous burden on interstate commerce. xxxxxxxxxxx business model uses the Internet as a platform upon which to provide telecommunications and energy services to customers in multiple states, gaining economies of scale and scope without incurring the capital expense of building facilities or staffing sales offices in States other than Massachusetts. National telecommunications policy from the 1984 consent decree that resulted in the break-up of AT&T through the Telecommunications Act of 1996 has allowed for and encouraged such non-facilities-based entry into national telecommunications markets. Taxing companies such as xxxxxxxxx that have made use of this mode of entry as though they had actual facilities and sales forces in all states from which they derive apportionable income would destroy many of the economies of scope and scale that were envisioned by Congress when it enacted the Telecommunications Act of 1996. Placing such a burden on interstate commerce is clearly forbidden by the Commerce Clause.

Based on the foregoing, xxxxxxxxx respectfully requests that you issue a letter ruling finding that it need not file a State income tax return. xxxxxxxxx believes that an expeditious response adopting that conclusion will serve both the taxpayer and the consumers of its services.

According to the Department of Revenue ("Department") regulations, the Department may issue only two types of letter rulings: Private Letter Rulings ("PLR") and General Information Letters ("GIL"). The regulations explaining these two types of rulings issued by the Department can be found in 2 Ill.Adm.Code §1200, or on the website http://www.revenue.state.il.us/legalinformation/regs/part1200.

The question of nexus is highly fact-dependent. Therefore, the Department does not issue private letter rulings regarding whether a taxpayer has nexus with the State. Such a determination can only be made in the context of an audit where a Department auditor has access to all relevant facts and

circumstances. As a result, we are required to respond with a GIL. GILs are designed to provide background information on specific topics. GILs, however, are not binding on the Department.

Section 201 of the Illinois Income Tax Act ("IITA"), 35 ILCS 5/101 et seq, imposes a tax measured by net income on corporations for the privilege of earning or receiving income in this State. You letter is correct in that the Due Process and Commerce Clauses of the Federal Constitution limit the power of States to subject foreign corporations to tax. However, and unless protected by Public Law 86-272, a foreign corporation has the requisite nexus to subject it to Illinois income tax where any part of its income is allocable to Illinois in accordance with the provisions of Article 3 of the Illinois Income Tax Act (35 ILCS 5/301-304, 308). Public Law 86-272 is a federal statute that prohibits a state's taxation of interstate sales of tangible personal property.

Activities relating to broker relationships involving sales of telephone and Internet services that result in a one-time bounty for acquiring customers are not included in the protection provided under the aforementioned public law. Your letter indicates that your contacts with Illinois include Internet service sales to Illinois residents. The result of your activities in Illinois provides your corporation with income from Illinois residents. As such, a portion of your income may be allocable to Illinois in accordance with provisions of Article 3 of the IITA. Accordingly, the Federal Constitution may not bar Illinois from subjecting your corporation to Illinois income tax.

If a corporation does establish nexus, business income will be apportioned to Illinois under Section 304 of the IITA. Illinois has used the 3-factor apportionment formula that takes into consideration the (1) payroll, (2) property and (3) sales of a corporation. Beginning with taxable years ending December 31, 2000, only sales will be used. This change to a "single-sales factor" will be phased in over a two-year period. Since you have no payroll or property within Illinois, the change does not effect your corporation. Should you have "nexus" with Illinois, you would use the amount of money that is retrieved from Illinois compared to the amount retrieved from all other states.

With respect to your question regarding our filing requirements, Section 502(a) of the IITA describes when an Illinois income tax return is required. Pursuant to Section 501(a), an Illinois income tax return is required in two situations. The first situation is when a taxpayer is liable for Illinois income tax. The second situation is, in the case of a corporation qualified to do business in Illinois, when the taxpayer is required to file a federal income tax return, regardless of whether such person is liable for Illinois income tax.

As stated above, this is a general information letter which does not constitute a statement of policy that either applies, interprets or prescribes tax law. It is not binding on the Department.

Sincerely,

Heidi S. Scott
Staff Attorney – Income Tax